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Research Update:

Dutch Dairy Company Koninklijke FrieslandCampina Outlook Revised To Negative; 'BBB+ / A-2' Ratings Affirmed

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Overview

- Dairy company Koninklijke FrieslandCampina N.V. (RFC) reported lower-than-anticipated operating margins in 2017, owing to historically high milk costs.
- This translated into S&P Global Ratings' adjusted debt to EBTIDA above 3.5x at year-end 2017, which leaves RFC with reduced headroom in its credit metrics for the current rating.
- We are therefore revising our outlook on RFC to negative from stable, and affirming our 'BBB+/A-2' ratings on the group.
- The negative outlook reflects our view that there is at least a one-in-three likelihood that we will downgrade RFC over the next 12-24 months, if it is unable to restore its credit metrics, notably if adjusted debt to EBITDA remains above 3.5x.

Rating Action

On April 25, 2018, S&P Global Ratings revised its outlook on Dutch dairy company Koninklijke FrieslandCampina N.V. (Royal FrieslandCampina or RFC) to negative from stable, and affirmed its 'BBB+' long-term and 'A-2' short-term issuer credit ratings on the group.

Rationale

The outlook revision follows RFC's release of its 2017 financial results, which showed lower operating margins at the group level than in our base-case projections. Profitability has been notably slashed by high milk price inflation, resulting in the group having limited leeway in the credit metrics for our assessment of its current financial risk category.

The group's profitability has been heavily hit, with reported EBIT dropping by more than 20% in 2017. This decrease in profitability is somewhat explained by the lag between the inflation of raw materials, and the effective price increase passed onto customers. In addition, now that the price increases are in place, we consider that the group will partially be able to recover its profitability, mainly in its branded division. RFC's Dairy Essential division could continue to suffer if prices remain stable, given that the pass-through

mechanisms are not effective on this commoditized business segment.

In terms of revenues, RFC remains the fifth-largest global dairy group (€11.1 billion as of Dec. 31, 2017), and ranks No. 3 in the global dairy cooperative industry. However, the group's product diversification and its exposure to more than 170 countries coupled with its product focus toward higher value added dairy products should drive margin recovery in 2018. Moreover, RFC's vertically integrated business model enables it to control and manage at all times the quality of its products and to maintain what we could consider the industry's most exclusive quality standard, the "From the Grass to Glass" approach. Currently, the group's strong product pipeline with important initiative on organic product should fuel growth in mature markets. Moreover, the group's ambitious increase in marketing spending will enable it to gain market share by expanding and strengthening its core brands, such as Frisian Flag, Dutch Lady, or Frizo Gold, in the Chinese market, and the Asia-Pacific region. Enhancement in profitability should also stem from operational improvement, especially thanks to a revamping of its logistic platform in the Asia-Pacific region resulting in a shorter route to market.

Last week, the group announced the launch of an open discussion with its member farmers in order to put in place well-balanced milk streams that will be based on market-driven growth. This should enable RFC to smoothen volatility of profitability in the long term. The group has a track record of achieving better returns to farmers than its peers, but current market conditions have led RFC to decrease its profit returns to farmers.

Despite lower profit returns to members, we believe the cooperative will be able to retain farmers in the coming years. RFC operates through four business divisions (effective as of Jan. 1, 2018): Consumer Dairy, Specialized Nutrition, Ingredients, and Dairy Essential.

Across its divisions, the group enjoys what we consider a well-balanced product portfolio, thanks to its efficient milk valorization model. This value-creation proposition for its farmers is one of the group's key strengths, which underpins our business risk profile assessment. Like other agricultural cooperatively owned companies, RFC is vertically integrated and engaged to buy all the raw materials (milk) produced by its member farmers. The group provides its members with better returns than peers thanks to its milk valorization model, which includes both the processing of large quantities of milk and maximizing of value creation via the production and marketing of dairy products.

In our base case for 2018-2019, we assume:

- Revenue growth of 5%-6% in 2018, primarily driven by price increases passed at end-2017. Increased marketing spending should support market share gains, notably in the Consumer Dairy and Specialized Nutrition divisions. For 2019, we anticipate slightly higher volumes, but limited price increases, resulting in flat revenue growth.
- Adjusted EBITDA margin of 9% in 2018, potentially recovering to 10% in

2019 if milk costs decline. We assume profitability should benefit from price increases, the growth in the high-margin Specialized Nutrition business in China and Southeast Asia, new consumer dairy markets like Philippines, Myanmar, and for example Pakistan, but also from fixed cost-saving measures.

- Capital expenditures (capex) remaining at about €500 million annually.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted debt to EBITDA of about 3.2x-3.6x in 2018, and about 3.0x-3.5x in 2019.
- A funds from operations (FFO)-to-debt ratio of 20%-25%.
- EBITDA interest coverage of about 15x.

Liquidity

We assess RFC's liquidity position as adequate, under our criteria for agricultural cooperatives. We forecast that liquidity sources to uses will exceed 1.2x over the next 12 months and that sources would exceed uses even in case of a 20% EBITDA decline. We note that RFC has significant headroom under the financial covenants on its senior debt.

We estimate that principal liquidity sources for the 12 months from Dec. 31, 2017, include:

- Cash and cash equivalents of €356 million as of Dec. 31, 2017;
- An undrawn revolving credit facility (RCF) of €1,000 million maturing in more than a year; and
- Our forecast of cash FFO of about €712 million for 2018.

For the same period, we estimate that principal liquidity uses include:

- Short-term debt maturities of about €661 million comprising €221 million of commercial paper undrawn at Dec. 31, 2017;
- Capex of €500 million for 2018;
- Maximum seasonal working capital requirements of about €350 million;
- Dividend payments of about €66 million in 2018; and
- Cash outflow of €171 million, mainly tied to return payments and interest on member bonds.

Outlook

The negative outlook reflects our view that there is at least a one-in-three likelihood that we will downgrade RFC over the next 12-24 months if RFC is unable to restore its credit metrics, notably if adjusted debt to EBITDA remains above 3.5x.

Downside scenario

We could lower the 'BBB+' long-term rating if RFC's operating performance remains constrained by operational headwinds, for example due to continued high raw material prices in milk and inability to rapidly pass on price increases to customers. If RFC is not able to improve the profitability of its high-margin Specialized Nutrition division, this could also weigh on the rating. Finally, any significant change in financial policy, notably regarding debt-financed acquisitions, could be negative for the rating.

Upside scenario

We could revise the outlook to stable if we saw tangible and sustained signs of deleveraging over the next 12-24 months. This is likely to come from a sustained recovery in operating margins thanks to price increases and stable growth in RFC's Specialized Nutrition division. This would imply an adjusted debt-to-EBITDA ratio in the 3.0x-3.5x range on a sustained basis.

Ratings Score Snapshot

Corporate Credit Rating: BBB+/Negative/A-2

Business risk: Strong

- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - Industrials: Key Credit Factors For Agricultural Cooperatives, March 17, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Koninklijke FrieslandCampina N.V. Issuer Credit Rating	BBB+/Negative/A-2	BBB+/Stable/A-2

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